

# Patent Licensing Royalty Rates: Everything You Need to Know

*Patent licensing royalty rates are a percentage of the gross or net profit made on each sale of a product. • 7 min read*

**Updated June 24, 2020:**

Patent licensing royalty rates are a percentage of the gross or net profit made on each sale of a product. Generally, a royalty is provided between the inventor (the licensor) and manufacturer, publisher, agent, or distributor (the licensee). Essentially, an inventor will enter into a license arrangement to have the manufacturer, publisher, agent, or distributor of the product sell it for the inventor. Since the licensee is doing the legwork, it will be the main party benefiting from selling the product; however, the license arrangement will establish a royalty rate, which is the rate the inventor will receive every time the product sells.

## Criteria for Receiving Royalties

One of the most significant steps in licensing an invention or idea is establishing the royalty rate the inventor wants to receive in return for granting a licensee the right to manufacture and sell the invention. Royalty payments are affected by a number of factors, including:

- **Upfront compensation:** The upfront compensation paid to the inventor will affect the royalty rate. For example, if an inventor receives a higher upfront compensation for the license arrangement, then the royalty rate will be less. However, if he or she receives a small amount of upfront compensation, then the royalty rate will be higher.
- **Company standard rates:** Generally, each industry has a standard royalty rate. Those companies that have experience in licensing tend to have standard rates that are applied to specific inventions. Of course, the larger the company, the more financial resources they have to offer a higher royalty rate.
- **Intellectual property stage:** The further along the invention is with regard to commercialization, the less risk the licensee will face, and thus, the higher the royalty rate will be.
- **Market potential:** The royalty rate will also depend on the market potential of the idea or invention itself. For example, if the invention relates to a newly developed type of market, then the royalty rate will be considerably less, as there is no way of telling whether or not it will be successful.

- Testing: To reiterate, the further along an invention is with regard to commercialization, which includes the extensive testing it must go through, the less risk a potential licensee will face.

## Types of Royalty and License Fees

Most patent licenses (<https://www.upcounsel.com/patent-licensing>) will indicate in the agreement that one or more of the following will be paid by the licensee: an up-front license fee (this is the upfront compensation mentioned above), continuous lump sum license fee payments, and/or rolling royalties. In certain circumstances, the inventor should grant a royalty-free license, such as if he or she is receiving another benefit. For instance, the inventor may also provide research services in return for compensation.

**TALK TO A TOP LAWYER FOR FREE**

Sometimes upfront compensation can be treated as a capital payment in which a restraint of trade agreement is filed rather than an actual license agreement. In this case, the inventor is likely selling the invention to the other party.

Below are some additional types of royalty approaches that an inventor and licensee will take in terms of the licensing arrangement being made between the parties.

### The Cost Approach

Using this approach, the royalty is a specific percentage that reimburses the owner for the costs over the entire life of the license (i.e. patenting costs).

### The Comparable Market Approach

If this approach is used, the royalty rate is based on the royalty offered by others in comparable industries. The flaw in this approach involves the inability to identify reliable data that can truly compare similarly situated deals. Examples of average royalty rates by industry are as follows:

- Aerospace, 4 percent
- Apparel, 6.8 percent
- Automotive, 3.3 percent
- Chemicals, 4.3 percent
- Computers, 4.6 percent
- Construction, 5.6 percent
- Consumer goods, 4.8 percent
- Electronics, 5.1 percent
- Energy and environment, 8 percent
- Health care equipment and products, 6.4 percent
- Industrial goods, 6.4 percent

- Machine tools, 4.8 percent
- Pharma and biotech, 6 percent
- Software, 9.6 percent

## The Income Approach

Generally, the income approach uses the 25 percent rule, which specifies that the inventor is eligible for 25 percent of the licensee's long-term pre-tax operating profit made from the sale of the licensed product. If using this approach, the agreement itself should indicate that the 25 percent will be on the net sales or, alternatively, a price per unit of each licensed product sold.

Keep in mind that the license agreement should never indicate that a royalty is to be collected on the percentage of profits because the licensee can often manipulate profits. So, for the 25 percent rule to be used, the inventor should be aware of the licensee's expected expenses and revenues. The inventor can ask that the licensee submits to him or her a business plan on what the company believes such expenses and revenues are. If the prospective licensee fails to do so, the inventor should not accept the deal.

## Discounts on Putting a Premium on Royalties

Both parties should keep in mind that the value of the product being sold may increase or decrease in price. There are several factors that can affect the value of a product, including after-market technology that may deem the product less useful, competing technologies, and the size of the market itself. These considerations should be made before choosing to put a premium, also referred to as a surcharge, on royalties.

## Market Value of an Invention

If royalties are solely based on the net sale of a product, be sure that the royalties reflect the market value for that product. The inventor will also want to ensure that the agreement sets forth any deductions from the net sale that may be included, which would reduce the net profit, thus reducing your compensation.

Fair market value is affected by diverse factors that may include:

- The type of intellectual property (<https://www.upcounsel.com/intellectual-property-law>) (IP) in question
- The stage of development of the product
- The availability of competing technologies
- Exclusivity of rights granted in the license agreement
- Strength of IP protection

- Market size and conditions
- Whether the product is a major breakthrough or a minor ancillary product in the field
- Uniqueness of the invention
- Risk
- Profit margins



## What's a Reasonable Royalty Rate?

Rates can vary between 0.1 and 25 percent or more depending on the industry and type of invention. Royalty guides can assist inventors in determining the right royalty rate. The inventor should do his or her homework in terms of:

- What the standard rates are
- How marketable the invention is
- The likelihood that other competitive technologies will be placed into commerce anytime in the foreseeable future
- Whether or not there is already a similar type of product being sold
- If the product itself can be purchased time and time again from a single customer or whether the product is a one-time purchase
- Whether the product will only spark interest in customers in certain geographical regions
- How many customers the product can reach

### Royalty Guides

These guides are published by organizations such as the Licensing Executives Society (<https://www.lesusacanada.org/>) and the Association of University Technology Managers (<https://www.autm.net/>). They offer a statistical analysis of royalty rates by industry, derived from actual license agreements. They do not include license agreements that resulted from litigation or threat of litigation.

Having numbers from the royalty guides provides a basis for negotiation, especially if a potential licensee is offering you a number that you think is too low.

Your business model is another resource that can support your desired royalty rate. Make sure to have the party in question sign a nondisclosure agreement before sharing this document.

It is never wise for an inventor to enter a potential licensing arrangement without knowing the industry standard or the value of the invention. Many online resources exist that can assist the inventor. Such literature should be read and studied before the inventor should even consider looking for potential licensees. After conducting this research, the inventor should look online for companies

that may be interested in licensing the product, while also learning more about each company — its net assets, where it operates, how many people are employed with the company, and other important factors.

Once the inventor has come up with a list of targeted companies, a meeting should be held in which the prospective licensee (the company) will provide the inventor with its business plan, assuming the company is interested in the product.

**TALK TO A TOP LAWYER FOR FREE**

The inventor should make sure that the potential licensee doesn't offer a royalty rate far below what the inventor seeks. Again, the inventor will have a list of target companies, so if the first company offers a substantially lower rate than what the inventor seeks, then the inventor should hold off on agreeing to it.

There is no “correct” royalty rate in terms of licensing a product. The royalty rate should, however, be the maximum rate that the licensee is willing and able to pay, which in turn meets the minimum royalty rate that the licensor (the inventor) is willing to accept.

## What Should Be Included in a License Agreement?

The agreement for a third party to license your product should include the following contract terms:

- Whether the rights are exclusive or shared with other licensees
- Whether payments will be made in advance or as the product sells
- Whether the license is transferable
- Whether it can be used in other markets and territories
- How long the rights last
- The circumstances under which the rights can be terminated

Ensure that the license arrangement includes specifics on the companies reporting requirements in terms of audited records so that the inventor can keep track of what is owed.

If you need help learning more about patent licensing royalty rates or if you need help drafting a license agreement, you can post your legal need ([https://www.upcounsel.com/jobs/new?page\\_location=article-paj-hyperlink-content](https://www.upcounsel.com/jobs/new?page_location=article-paj-hyperlink-content)) on UpCounsel's marketplace. UpCounsel accepts only the top 5 percent of lawyers to its site. Lawyers on UpCounsel come from law schools such as Harvard Law and Yale Law and average 14 years of legal experience, including work with or on behalf of companies like Google, Menlo Ventures, and Airbnb.



212



4



51



**TALK TO A TOP LAWYER FOR FREE**